

A New Tax Framework

A Blueprint for Averting a Fiscal Crisis

EXECUTIVE SUMMARY

The U.S. fiscal system faces two major problems. The first is an impending fiscal crisis; large and growing Federal budget deficits will soon threaten our economic growth and living standards. The second problem is that the tax system has become unnecessarily complex and riddled with inequitable special preferences that distort our market economy. These two problems are closely related: an ineffective tax system cannot raise the revenues required to finance Federal expenditures and restrain budget deficits without placing heavy burdens on the economy and society.

The fiscal crisis ahead will be driven largely by the impact of escalating health care costs on Medicare and Medicaid expenditures and by the demographics of an aging society. *These cost pressures will be so intense that fundamental changes in our health care system, and correspondingly large reductions in the growth of Medicare and Medicaid spending, are unavoidable.* Taxes to cover federal expenditures that rise exponentially to 30, 40, and 50 percent of GDP would overwhelm the economy.

Expenditure reductions alone will not be enough. Congressional Budget Office projections indicate that even aggressive and painful changes to reduce Medicare and Medicaid expenditures, with other spending restraints, are unlikely to restore fiscal balance if federal revenues remain at historical levels. As CED argued in its 2003 budget statement, the nation must undertake a budgetary "war on all fronts" by reforming entitlement programs, reducing discretionary (annually appropriated) spending, *and* by raising additional revenues. This policy statement focuses on revenues and the tax system.

In theory, additional revenues could be provided simply by raising income tax rates. However, the current income tax system is complex, inefficient, and inequitable. Raising the tax rates of this dysfunctional system would compound existing distortions and disincentives, further damaging the economy.



The income tax therefore should be reformed by eliminating, reducing, and consolidating special tax preferences to the extent feasible. Doing so will make the system simpler, fairer, and more efficient, promoting economic productivity and growth. However, even an improved income tax is unlikely to meet our revenue needs, because there are major political and policy constraints on how far we can go in eliminating such preferences and broadening the income tax base. Indeed, a simplification and base-broadening program that repeals the Alternative Minimum Tax (AMT)--the most complex and problematic feature of the current system--is likely to raise *less* revenue than the present system.

In addition, raising income tax rates will prove a counterproductive long-term strategy for increasing revenues, as globalization makes capital more mobile. Domestic production and jobs will become more likely to move offshore, and the burden of capital income taxation will increasingly be shifted to workers.

We therefore need a new revenue source to supplement an improved income tax. CED proposes a national value-added tax (VAT), combined with modifications to the income tax (including a refundable low-income credit) that will shield the poor from the VAT and preserve overall tax progressivity. The United States needs *both* a VAT *and* a simpler, progressive income tax--the former to raise additional revenues on a very broad base in an economically neutral manner, the latter to preserve the fairness of the tax system.

This new hybrid tax framework would greatly improve the U.S. fiscal outlook. The additional revenues raised in the CED tax framework, if combined with spending restraint, would eliminate projected deficits and produce budget balance or surpluses for a number of years. The new revenues would not only reduce deficits and debt directly, but, by forestalling an explosion in interest costs, allow us to "buy time" to restructure health care and other expenditure programs.

The proposed CED tax framework would raise net revenues by about 3.7 percent of GDP; an increase in income tax rates of 35-40 percent would be required to produce equivalent revenues.

Taken together, CED's recommendations involve major changes in our tax system. However, unlike some "fundamental tax reforms" that involve scrapping the income tax entirely and thereby creating enormous problems for the transition to a new system, this "hybrid" system would be more feasible politically and could be more easily implemented. The fundamental structure of the income tax would not change, and the journey to a VAT, which would admittedly require many difficult choices, would take place on the well-prepared ground that over 100 other nations have covered in recent decades.

Summary of CED's Recommendations

- 1. Eliminate and Reduce Tax Preferences, Simplify the Tax System, and Broaden the Tax Base.** We should remove unnecessary complexities and reduce or eliminate tax preferences that do not have a compelling rationale. Remaining preferences should be consolidated and simplified, and in some cases deductions should be converted into credits.
- 2. Phase In a Broad-Based 10 Percent Value-Added Tax (VAT) To Supplement the Income Tax.** A VAT would provide additional revenues to help meet the impending fiscal crisis and to allow lower income tax rates (and thus fewer economic distortions) than would otherwise be required. The VAT base should be as broad as possible to enhance both economic neutrality and revenues.
- 3. Modify the Income Tax To Protect Low-Income Households and Support Progressivity.** The income tax can address the VAT's regressivity with the restructuring and expanding of a refundable low-income tax credit, modifying income tax rates for those with tax liability, and increasing the standard deduction to raise the tax-entry threshold.
- 4. Repeal the Individual and Corporate Alternative Minimum Taxes.** With AMT repeal, those targeted provisions of the AMT that discourage aggressive tax shelters should be incorporated into the regular income tax. *The introduction of a VAT and repeal of the AMT must be accompanied by changes in the income tax rate structure, standard deductions, and low-income credits to support the progressivity of the overall tax system.*
- 5. Rationalize Capital Income Taxation by Integrating the Individual and Corporate Income Taxes, Narrowing the Differential Treatment of Ordinary Income and Capital Gains, and Modifying the Estate and Gift Taxes.** We should tax capital income once, but only once, at rates that approximate those on other forms of income. The differential between the top rate on ordinary income and that on capital gains should be narrowed to reduce incentives for arbitrage and tax shelters. The estate tax should be retained, but reformed. One option would be to continue in 2010 and thereafter the scheduled 2009 exemption of \$3.5 million (\$7 million for couples) and top rate of 45 percent, with the exemption indexed for inflation.
- 6. Improve the Processes for Making Tax and Budget Policies.** Process changes are essential to help protect a new tax framework against renewed onslaughts of complexity, and the budget from revenue erosion.
- 7. Provide the Internal Revenue Service with Political Support and Resources** required to support the integrity and revenue-raising capacity of the tax system.

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